# III. THE FCC SHOULD PERMIT MORE PASS-THROUGHS FOR EXOGENOUS COSTS.

In order to reduce the administrative burdens imposed by rate regulation on small systems, the Commission should permit the pass-through of additional exogenous costs under the benchmark regulatory scheme. Otherwise, these costs will eventually force virtually all systems into making cost-of-service showings. Even though standards have not yet been developed for the cost-ofservice procedure, there is no question that such procedures will demand much more research, analysis and preparation -- at the system level, the franchise level, and the FCC level -- than making pass-through adjustments to price-cap rates. Moreover, there is no reason not to permit the pass-through of costs over which a system has no control. Again, such costs would clearly be permitted to be recovered under cost-of-service procedures, but because these costs are independently established and outside the control of the system, there should not be any question regarding the system's right to recover them. Accordingly, it is appropriate to permit these costs to be recovered pursuant to a direct pass-through procedure rather than a full-blown cost-of-service proceeding, which should be reserved for cases where the amount of or right to recover a particular cost is controversial.

In determining which costs should be permitted to be passed through, the Commission should take care not to provide disincentives for the addition of channels or the improvement of programming. Specifically, systems with rates below the benchmarks should not be discouraged from adding new channels by the new regulatory structure. And yet, as it is currently configured, the Commission's benchmark/price-cap structure would punish those systems adding channels or improving programming in certain instances. For example, for systems with below-benchmark rates as of April 5, 1993, it is unclear whether programming costs associated with the addition of channels would be permissible pass-through items.

If a system with rates currently above the benchmarks adds a satellite channel, the overall rate permitted under the benchmark is adjusted slightly upward by the addition. 9/ But if a system with rates already below the benchmarks adds a channel, there is no apparent mechanism to pass through any of the costs of the new channel, including programming expenses. The Commission should clarify that the addition of channels qualifies as an "increase" in programming costs that may be passed through to subscribers.

In addition, other costs associated with adding channels must be included as pass-through items in order for the rules not to discourage the expansion of programming options. For example, headend costs and costs for improving the distribution plant required by the addition of channels must be treated as pass-through items. These costs can be substantial, especially for small systems with hundreds of headends, each serving only a few subscribers. One Small System Operator, serving approximately 304,734 subscribers from 416 headends, estimates that the cost of adding a single channel of programming throughout all of its systems would be about \$748,000, or \$2.45 per subscriber. By contrast, the operator estimates that adding the same channel to an urban system

launch. Small systems tend to have many fewer channels today than do larger suburban and urban systems. 10/ Thus, small systems face a greater need to expand channel capacity. Small systems' ability to pass through these costs is made even more critical at this time by must-carry requirements, which are forcing many small systems to increase their channel capacity. Yet under the Commission's price cap system, none of the costs of expanding the amount of programming offered by a cable system may apparently be passed through. Unless the Commission seeks the eradication of small systems, their costs of increasing programming selection must be permitted to be passed through.

# IV. IT IS IMPERMISSIBLE FOR THE FCC TO THREATEN TO PUNISH SYSTEMS SEEKING TO JUSTIFY RATES BASED ON COST-OF-SERVICE PROCEDURES.

The FCC cannot offer the cost-of-service alternative as a constitutional escape valve on the one hand while threatening to punish those who use it on the other hand. Moreover, the threat to use the results of cost-of-service procedures to reduce rates to below-benchmark levels undermines the whole benchmark scheme of regulation. The Commission will adopt rate benchmarks in this proceeding which, for better or for worse, will be deemed by the FCC to represent per se reasonable rates. To then second-guess the reasonableness of the benchmark rates based on information submitted by a system in a cost-of-service proceeding would call into question the concept that all benchmark rates are per se reasonable. This is particularly troubling in view of the FCC's decision to establish benchmarks based on historical pricing, and not based on cost. Cost data was not even solicited from systems in the FCC's rate survey. The failure of the FCC even to solicit cost

<sup>10/</sup> The FCC's random sample of systems shows that the average system with more than 1,000 subscribers has 33.3 channels of programming, while the average small system has only 20.2 channels of programming.

data belies its concern that prices should be based on costs. Indeed, this lack of interest in cost-based data exposes the FCC's statement that it would reduce rates to below-benchmark levels -- if a cost-of-service procedure fails to justify the benchmark rate -- as a threat of punitive action, designed to discourage the pursuit of cost-of-service procedures. If the FCC were truly motivated by a concern that pricing be based on costs, it would have solicited cost data rather than pricing data in its rate surveys.

In order to preserve the viability of cost-of-service procedures as a constitutional safety valve, and to preserve the validity of the per se reasonable benchmark rates, the Commission must not threaten to reduce rates to below-benchmark levels based on the outcome of a cost-of-service procedure.

#### CONCLUSION

In view of the unique costs and administrative burdens faced by small systems (with less than 1,000 subscribers), the Coalition of Small System Operators hereby requests that the Commission adopt a simplified regulatory scheme for small systems. Under this scheme, small systems would be deemed to have reasonable rates if their net income is below a certain level (determined as a percentage of gross revenues). Small systems with net income above that level could undertake a benchmark analysis, with adjustments to rates for systems with density of less than 30 homes passed per mile. Finally, small systems would have

risks undertaken by the small entrepreneurs building these rural systems, often agreeing to higher rates than average so that their towns will have access to cable television. Federal intervention now threatens to interfere with those arrangements on which many small operators relied when they brought cable service to sparsely populated areas.

The Commission has recently suggested in various forums that it desires to reduce the administrative burdens on small systems. We believe that this Petition for Reconsideration spells out in detail reasonable ways for the Commission to do so. We also believe that it is beyond question that the Commission's rate regulation rules, as promulgated, do not meet the statutory solicitude for small systems. The Commission has an opportunity now, before the stay is concluded, to meet its obligations under the 1992 Cable Act. We respectfully request that it do so.

Respectfully submitted,

COALITION OF SMALL SYSTEM OPERATORS

Gardner F. Gillespie Jacqueline P. Cleary

HOGAN & HARTSON 555 13th Street, N.W. Washington, DC 20004 202/637-5600

Dated: June 21, 1993

NAME OF OPERATOR	TOTAL SUBS	TOTAL COMM. UNITS	TOTAL STATES SERVED	TOTAL HEADENDS	HEADENDS WITH LESS THAN 1,000 SUBS.
Douglas Communications Corp. II	103,090	494	13	437	428
Galaxy Cablevision	54,887	200	6	129	112
MW1/USA Cablesystems, Inc.	37,334	484	16	443	443
Vantage Cable Associates, L.P.	30,737	126	7	126	123
Triax Communications Corp.	326,052	1,075	16	444	361
Buford Television, Inc.	77,206	260	8	168	154
Classic Cable	29,904	78	5	73	65
Midcontinent Media, Inc.	72,502	174	4	170	162
Star Cable Associates	60,279	150	6	62	33
Leonard Communications, Inc.	61,500	226	9	125	110
Phoenix Cable, Inc.	26,900	58	8	37	25
Harman Cable Communications	32,500	29	6	22	15
ACI Management, Inc.	26,000	125	8	45	39
Frederick Cablevision	41,427	21	1	9	3
Fanch Communications	189,603	514	13	306	331
MidAmerican Cablesystems, L.P.	12,173	101	5	81	80
Schurz Communications	56,232	9	1	3	1
Rigel Communications	10,500	31	2	31	29
Western Cabled Systems	6,758	10	1	9	7
Horizon Cablevision, Inc.	23,347	81	1	16 .	6
Community Communications, Co.	12,167	35	2	28	28
Balkin Cable	6,758	10	1	29	4

### FOR SYSTEMS WITH FEWER THAN 1,000 SUBSCRIBERS

NAME OF OPERATOR	AVERAGE SUBS.	AVERAGE HOMES PASSED PER MILE	AVERAGE MILES PLANT	AVERAGE ACTIVATED CHANNELS	AVERAGE SUBS. PER MILE
Douglas Comm. Corp. II	191	40	8	16	24
Galaxy Cablevision	396	37	19	28	20
MW1/USA Cable Systems, Inc.	84	29	7	21	12
Vantage Cable Associates, L.P.	221	45	7.23	21	30
Triax Comm. Corp.	364	39	15	22	25
Buford Television, Inc.	322	24	29	<b>24</b>	11
Classic Cable	331	51	10	25	39
Midcontinent Media, Inc.	240	57	5.85	16	41
Star Cable Associates	429	28	32	26	13.4
Leonard Comm., Inc.	252	40	9.6	19.9	26
Phoenix Cable, Inc.	313	24.4	24.6	18	12.7
Harman Cable Communications	410	47	8.8	21	46.9
ACI Management, Inc.	426	21.3	42.3	25	10
Frederick Cablevision, Inc.	511	33.5	22.3	40	32.9
Fanch Communications, Inc.	462	40.44	10.64	28	24.1
MidAmerican Cablesystems Limited Partnership	150	49	6.2	19.4	24.2
Schurz Communications, Inc.	440	55	8	30	55
Rigel Communications, Inc.	275	15	5	18	10.5
Western Cabled Systems	549	73	21.8	36.7	37
Herison Cohlassising	507	21	<u> </u>	മെ	മെ

# Mnited Blates Benate

March 5, 1993

Mr. James H. Quello Chairman Federal Communications Commission 1919 M Street, N.W. Washington, DC 20554

Doar Mr. Chairman:

As the Congressional Delegation from the state of South Dakota, we are writing relative to the implementation of the Cable Television Consumer Protection and Competition Act of 1992. When you consider the important service provided to rural areas by small cable system operators, we hope you bear in mind the particular problems of many small systems. The people of South Dakota have a special understanding of the burdens faced by small systems. Many of our constituents reside in sparsely populated areas where only small operators have been willing to offer multichannel video programming.

The rules crafted by the Commission should take into account the special danger of excessive administrative burdens on these small systems. Congress specifically recognized the danger of overburdening systems with less than 1,000 subscribers in the context of the rate regulation provisions in the 1992 Cable Act. The Commission, too, should be wary of imposing excessive administrative tasks which could stunt the growth of small systems and diminish service to rural America. There are three areas where excessive regulation of small systems is of particular concerns customer service, antitrafficking and rate regulation.

We support the idea of customer service standards for cable systems. Nevertheless, the imposition of industry-wide standards on small systems could unfairly punish operators who have limited resources available. We therefore urge the Commission, where appropriate, to consider an exemption from Commission rules regarding certain customer service requirements for systems with fewer than 1,000 subscribers. For example, telephone answering requirements or service and installation deadlines could be unduly burdonsome in situations where small systems would have great difficulty achieving the requirements without the substantial expense of purchasing equipment or hiring additional employees. Of course, franchise authorities would retain the ability to regulate all aspects of customer service practices, but we believe these decisions are best left to the local authorities who understand the special situations faced by small cable operators.

The anti-trafficking rules, and specifically the three-year holding period requirement, may also pose disproportionate problems for small systems and in some cases, could serve as a detriment to consumers. Bucause of their marginal operations and the economies stemming from acquiring geographically clustered systems, the Commission should consider granting systems with fewer

Mr. James H. Quello February 19, 1993 Page two

than 1,000 subscribers a waiver of the three year holding period requirement. There is little danger that trafficking in these small systems would become widespread (especially because many franchise authorities already regulate the sale of cable systems), and application of this rule to small systems could jeopardize their continued viability.

The greatest potential threat to small systems is rate regulation that does not take into consideration the unique problem faced by small systems. We encourage the Commission to consider separate rate benchmarks for systems with fewer than 1,000 subscribers. Most importantly, the Commission should recognize that small operators have limited revenue opportunities. Small system benchmarks should not unduly restrict the few revenue streams available to small systems. The Commission should also recognize in its rules that local franchise authorities are in an advantageous position to determine whether regulation of a given system's rates is warranted. If a franchise authority decides not to seek certification to regulate rates, the Commission should take into account that decision and consider leaving those rates unregulated until such time, if any, as the franchise authority requests certification.

The valuable service provided by small operators to residents of South Dakota and throughout the country should be encouraged and regulation should be tailored so as not to adversely affect the ability of rural cable systems to extend their services to sparsely populated areas. The 1992 Cable Act provides the Commission with discretion to separately regulate small systems and, where appropriate, exempt those systems from the rules or waive the rules in order to accommodate the special circumstances in which these systems operate.

Thank you for your attention to this important matter.

Sincerely,

Larry Bass er

CC: Commissioner Sherrie P. Marshall Commissioner Andrew C. Barnett

Commissioner Ervin S. Duggan



# FEDERAL COMMUNICATIONS COMMISSION WASHINGTON

MAR 2 9 1993

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Honorable Tom Dasoble United States Senate 317 Hart Senate Office Building Washington, DC 20510

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#### DECLARATION OF DEAN WANDRY

- I, Dean Wandry, hereby declare under penalty of perjury that the following is true and correct to the best of my knowledge, information and belief:
- 1. My name is Dean Wandry. I am Vice President,
  Operations, Fanch Communications, Inc. Fanch and its
  affiliates operate 290 headends in approximately 460 franchise
  areas in eleven states, and provide cable service to
  approximately 195,000 subscribers. Fanch's systems have an
  average of 672 subscribers.
- 2. Fanch operates a large number of cable systems that would be severely affected by application of the Federal Communications Commission's rate regulation benchmarks.
- 3. For example, Fanch operates a cable system in Greystone, Colorado. Fanch built the system in 1988-89 and currently provides 26 channels of non-premium video programming to 557 subscribers.
  - 4. In 1992 the system had total revenues of \$207,984.
- 5. During the same period, the system experienced operating expenses of \$101,834. The depreciation for the system was \$62,000, and the interest expense for the system was \$34,752.

- 6. During 1992, therefore, the Greystone system had net income of \$9,398.
- 7. The FCC benchmark methodology would require Fanch to reduce the revenues from regulated services in the Greystone system by a total of \$18,744.
- 8. Fanch projects that for the next 12 months, it will have revenues of \$214,584, operating expenses of \$106,926, depreciation of \$62,000, interest expense of \$34,752, and a net profit of \$10,906.
- 9. Were Fanch to reduce its rates (and revenues) by that amount, the system would experience a net loss of \$7,838 for the next 12 months.

Cost to construct	<b>1636.000</b>			
Basic Subscribers	263		W	
	·	Original	Impact of	Revised
	Actual	Budget	Regulation	Rudget
	1902	1983	1983	1993
Senic and Ancillary Revenue	<b>6174,372</b>	<b>#180,872</b>	(\$18,744)	<b>\$162,228</b>
Pay Revenue	433,612	433,612	•0	<b>#33,612</b>
Total Revenues	<b>\$207,984</b>	<b>4214,584</b>	(#18,744)	<b>\$195,84</b> 0
Operating Expenses	<b>\$101,834</b>	<b>\$106,926</b>	•0	<b>\$106,926</b>
Depreciation	<b>#62,000</b>	<b>462,000</b>	<b>40</b>	<b>#62,000</b>
Interest (B)	<b>434,7E</b> 2	434,762	•0	<b>434,752</b>
Not Income (Leas)	49,308	\$10,906	(\$18,744)	(87,838)

<sup>(</sup>A) Assumes regulation for the entire year of 1983

10. Under the FCC's rules and other pronouncements, Fanch must decide by June 21, 1993, whether to (i) shut the system down, ceasing service to 563 subscribers; (ii) reduce rates according to the FCC's benchmark methodology to the point where revenues do not cover all of the system's expenses; (iii) retain the existing rate structure based on a cost-of-service

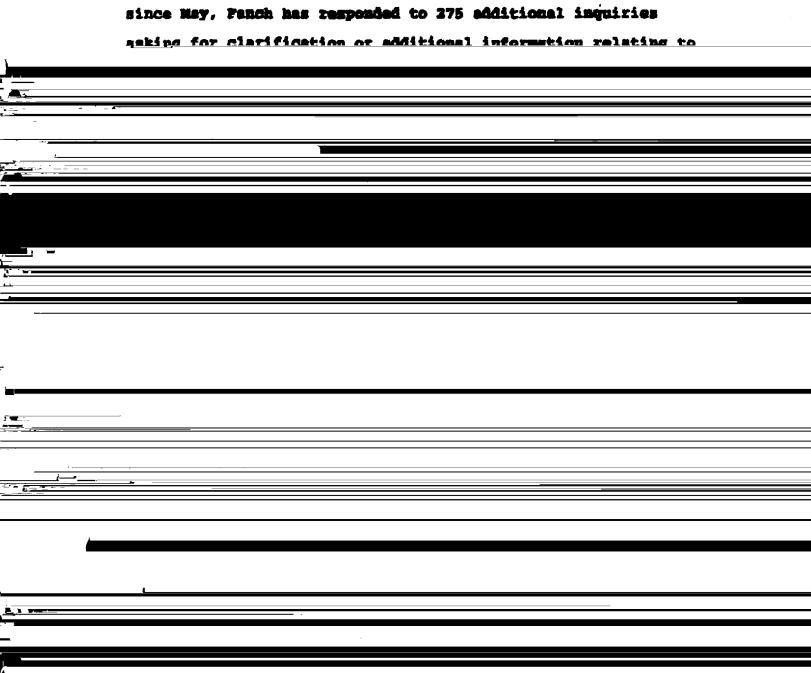
subscribers back to June 21, 1993, for any charges above those justified by the FCC's analysis. Therefore, if Fanch chooses to retain its current rates based on a cost-of-service analysis, it runs the risk that its net losses could be even higher than the losses that would be generated for the period after June 21 under the benchmarks.

- regulation order on May 3, 1993. The order contains approximately 50 pages of forms and instructions. On May 13, 1993, the FCC held a videotaped, satellite-delivered public meeting in which FCC staff members spent more than an hour explaining how to fill out the benchmark forms. Since that meeting, the FCC has issued various other pronouncements concerning the benchmark system. Fanch has attempted to understand the benchmark methodology and to perform the necessary analyses for its systems.
- 14. At this point, Fanch has completed benchmark calculations (including equipment and installation charges) for only six systems. We expect that we will be able to complete the analysis for 30-40 systems in time to make adjustments before June 21, 1993. We will simply be unable to complete the analyses for the other 250-260 systems by that time. Eventually, according to the FCC's instructions, we must complete the benchmark analysis for each franchise area, of which Fanch has approximately 460. Even if the cost-of-service

were available, therefore, Fanch would not be able to make decisions regarding the proper rate structures for many of its franchises by June 21, 1993.

operators with numerous besidence, I note that Fench sent out
1,259 letters to broadcasters by the May 2, 1893 deadline under
the new signal carriage rules. In addition, Fanch sent out
2,721 notifications to broadcasters on June 1, 1992. And,
since May, Fanch has responded to 275 additional inquiries

neking for clarification or additional information relating to



#### **DECLARATION**

I, the undersigned, hereby declare under penalty of perjury that the following is true and correct to the best of my knowledge, information and belief.

Douglas Communications Corp. II ("Douglas") is the managing general partner of five limited partnerships, which, as of March 3, 1993, owned and operated cable television systems consisting of a total of approximately 468 franchises and approximately 414 headends which served approximately 102,000 subscribers. However, approximately 406 of Douglas' 414 headends were for

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additional time to complete the calculations and conduct the analysis necessary to calculate the impact of and to comply with the FCC's regulations. The Commission should not require compliance with the benchmarks until the parameters of the cost-of-service alternative are defined.

Michael J. Poki

Senior Vice President,

Douglas Communications Corp. II

Dated:

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#### **DECLARATION**

I, William Shew, hereby declare under penalty of perjury that the following statements are true and correct:

I am Director of Economic Studies, Arthur Andersen Economic Consulting. I have engaged in numerous studies of the economics of cable systems and television markets in the United States and Europe. My curriculum vitae is attached.

I have been asked to examine the foundation of the benchmarks proposed by the FCC to regulate the prices of basic cable services, particularly as those benchmarks apply to small cable systems, defined as having fewer than 1000 subscribers. The benchmarks are intended to describe the prices that "competitive" cable television systems would charge for basic cable service packages. The FCC recognized that the prices charged by a cable system — whether it is "competitive" or not — depend on characteristics of the service it provides. The FCC's schedule of competitive benchmarks is a function of (1) the number of system subscribers, (2) the number of channels available on all regulated tiers, and (3) the number of satellite-delivered channels on all regulated tiers. The FCC plans to prohibit any "non-competitive" cable system from charging service prices higher than the benchmark prices that, according to its analysis, a "competitive" cable system would charge in the same circumstances.

My conclusions concerning the statistical validity and the soundness of the benchmarks can be summarized as follows:

- 1. There are inaccuracies in the FCC data used to develop the benchmarks. Determining how these inaccuracies have affected the benchmarks would be quite difficult.
- 2. The FCC's sample of small competitive systems is quite small, with the result that the benchmarks derived by the FCC are characterized by a significant degree of uncertainty.
- 3. A number of the systems used to develop "competitive" benchmarks are municipal systems or private systems engaged in price wars, whose prices would tend to understate the prices that are sustainable in long-run competition.
- 4. The FCC benchmark equation does not adequately predict the prices charged by small, competitive cable systems.

I will begin by summarizing how the FCC constructed its benchmarks, which is necessary to understand their infirmities. I will then explain my reservations about the benchmarks.

#### **Benchmark Construction**

To develop its competitive benchmarks, the FCC began by sending a questionnaire to systems serving 748 cable franchises, out of a total of approximately 30,000 cable franchises operating in the U.S.. Of the 748 surveyed franchises, 300 were randomly selected. The remainder consisted of at least one franchise belonging to each of the largest 100 cable systems and franchises where the FCC believed that "effective" competition was taking place. Cable systems were asked to report, for basic cable service packages they provided, how many channels and satellite-transmitted channels were supplied and the price that was charged, as of September 30, 1992. They were also

asked to report the number of subscribers to each service, and various other information.

Much of the information requested by the FCC is specific to individual franchise areas served by the selected cable systems. Quite commonly, a single cable television system serves adjacent communities or areas that, from the perspective of local franchising authorities, consist of separate franchises. The operator customarily provides the same set of service options throughout the service area, charging a price for each that does not vary from one franchise to another. But since "competition", as defined by the FCC, can be present in one of a cable system's franchise areas and not others, the basic unit of observation in the database developed by the FCC is cable service in a franchise area.

For each of the cable systems, the FCC requested information on a "primary" franchise and, if the system's service territory consisted of more than one franchise, a second franchise. A system's "primary" franchise was defined by the FCC as the franchise drawn in the sample. The "secondary" franchise was to be chosen by the system to favor examples of effective competition, different channel line-up or prices, and large subscriber size. Of the 687 systems returning valid questionnaires, 267 reported on only a primary franchise and 420 reported on a primary and secondary franchise.

After compiling the data reported by the surveyed cable systems, the FCC then selected a subset of the responses, which it used to develop the competitive benchmarks. Although the details of this winnowing process remain imprecise, the following steps were apparently employed. First, the FCC eliminated cable franchises for which the reported data contained important